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C O N F I D E N T I A L SECTION 01 OF 05 BAKU 001260

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DEPT FOR EUR/AS FRIED AND DAS BRYZA, ALSO FOR EUR/CARC, OBO
FOR GENERAL WILLIAMS, USDOC FOR U/S LAVIN AND DG ISRAEL
HERNANDEZ

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SUBJECT: PRESIDENT ALIYEV LAYS OUT STRATEGIC VISION FOR
SUSTAINABLE DEVELOPMENT TO CHAIRMAN LUGAR

REF: BAKU 1248

Classified By: Ambassador Anne E. Derse, per 1.4 (b,d).

11. (C) Summary: In an August 21 office call and subsequent dinner, President Aliyev laid out for SFRC Chairman Lugar his strategic vision for Azerbaijan's sustainable development, including plans for infrastructure improvements, investment in the non-oil sectors, poverty reduction and environmental programs, and increased spending on education and social programs. Aliyev said that increased human capacity would be required to implement his modernization vision, adding that he was considering a new Presidential Scholarship Program to send young Azerbaijanis to study abroad. Aliyev said that his goal was to ensure that Azerbaijan's economy continued to prosper after Azerbaijan's energy revenues are exhausted in the next 30-50 years. Aliyev said that he recognizes the dangers inherent in increased government spending (and admitted that the GOAJ had seen some signs that the economy was over-heating), but offered little detail on GOAJ plans to prevent hyper-inflation. Aliyev added that he faces strong popular pressure to spend the energy revenue now. Lugar cautioned Aliyev that continued democratic development also would be important for Azerbaijan's long-term prosperity. Aliyev agreed, but argued that an evolutionary approach -- particularly one where parliament supports the Executive Branch's work -- was necessary in Azerbaijan. (Comment: Like a good CEO, Aliyev has a solid vision; the question is whether Azerbaijan has the capacity and will throughout the government needed to implement the tough decisions that lie ahead.) Aliyev also confirmed his offer to provide a site for the New Embassy Compound as a gift to the USG. End summary.

12. (U) The Ambassador and Senate Foreign Relations Committee Chairman Richard Lugar (R-IN) paid an office call on President Aliyev on August 21. Chairman Lugar was accompanied by SFRC Staff Ken Myers II, Ken Myers III, OSD/Policy CTR Director Jim Reid, OSD/CTR Policy Advisor Andy Weber, Captain Gene Moran, and pol/econ chief (notetaker). Aliyev was accompanied by his Foreign Policy Advisor Ambassador Novruz Mammadov. Later on August 21, Aliyev hosted a dinner in honor of Lugar. The entire CODEL, accompanied by Ambassador and pol/econ chief, attended the dinner; Aliyev was accompanied at the dinner by Foreign Minister Elmar Mammadyarov and former Azerbaijani Ambassador to Washington Hafez Pashayev (recently appointed as Deputy Foreign Minister and Dean of Azerbaijan's new Diplomatic

Academy).

13. (U) Aliyev welcomed Lugar to Azerbaijan, noting that his trip was important not only to advance US-Azerbaijan bilateral relations, but also to demonstrate to countries throughout the region the strategic importance of good ties between the US and Azerbaijan. Aliyev noted that he was "very satisfied" with his April visit to Washington, telling the Chairman that bilateral relations continued to develop successfully in all areas following the Washington visit. Lugar responded that he had come to Azerbaijan with a great deal of excitement, eager to learn about Azerbaijan's stunning economic growth and the opportunities that growth presents to the Government of Azerbaijan to ensure that the Azerbaijani people's lives are improved. (Television cameras were present during the opening of the meeting, and both Aliyev's and Lugar's initial remarks were broadcast.)

NEW EMBASSY COMPOUND

14. (SBU) The Ambassador thanked Aliyev for his offer to give -- as a gift -- property to the United States for the site of a New Embassy Compound. The Ambassador noted that the property and subsequent New Embassy Compound would be a symbol of the strong and growing relations between our two countries; if the site were quickly identified and secured, the USG would be able to move much more quickly on construction, perhaps advancing the schedule by as much as two years. As soon as we have a written offer from the Government of Azerbaijan, the Ambassador said, we can proceed. Aliyev responded that he had just checked with the State Property Commission (SPC) earlier that day and had been

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told that three areas had been chosen that the embassy would evaluate two. He added that he understood the embassy had already rejected one site. (We later asked Presidential Foreign Policy Advisor Novruz Mammadov and Foreign Minister Mammadyarov to ensure that President Aliyev understands that the Embassy has not yet received written offers for any of the three sites, nor have we rejected any of them. As an apparent result, the SPC asked to meet the DCM on August 24.)

A VISION FOR SUSTAINABLE DEVELOPMENT

15. (SBU) Briefing Aliyev on his visit to the West Azeri oil platform and luncheon discussion with Minister of Economic Development Heydar Babayev on Azerbaijan's development goals, Lugar asked Aliyev to outline his own vision for Azerbaijan's sustainable development. Specifically, how did Aliyev plan to translate Azerbaijan's enormous energy revenue into improved services and infrastructure -- including environmental clean-up -- that would improve the lives of Azerbaijani citizens? Aliyev responded that the two issues -- energy and sustainable development -- were inter-related. Without energy, he said, none of Azerbaijan's development plans would be realistic. The challenge, he added, is to translate Azerbaijan's significant financial resources into human resources.

16. (SBU) Aliyev said he had begun thinking about this problem in 2004, when he first created a rural development program. Aliyev said that Azerbaijan faces a huge potential danger of mass rural migration to Baku, which he hopes to stop through the creation of decent conditions and opportunities outside Baku. (Minister of Economic Development Babayev separately told Chairman Lugar that rural migration already is a pressing problem for the GOAJ, as Baku's population is now estimated at 3.5 million.) Aliyev said that poverty reduction and job creation were an integral part of his approach. In 2005, he said, Azerbaijan had reduced poverty from 49 percent to 29 percent; he hopes to entirely eliminate poverty by the end of 2007. (Aliyev said that Azerbaijan measures poverty by the common world standard

of per capita income of less than USD 2 per day.) Aliyev added that over the last two and a half years, Azerbaijan had created 435,000 new jobs.

17. (SBU) Infrastructure development also factors into Aliyev's vision; he said that Azerbaijan plans to build six new power stations by the end of 2007, each with a capacity of 1,000 megawatts. Aliyev also plans to build highways, connecting Azerbaijan to its neighbors, and wants to improve Azerbaijan's water supply. Aliyev said that Azerbaijan is in the process of completing a new USD 300 million water pipeline that will bring potable water from northern Azerbaijan to Baku. Aliyev also plans to improve health care throughout the country, building ten modern regional hospitals that will ensure citizens have easy access to a degree of care previously available only in Baku. Aliyev agreed with Chairman Lugar that Azerbaijan's environmental issues were of concern, and said that he had recently convened a Cabinet Meeting to discuss the issue, instructing his Ministers to develop a program to clean up "all areas." Aliyev noted that the World Bank already had expressed interest in the project, and was working on a plan to clean the entire Absheron peninsula and Baku Bay in the next 2-3 years.

18. (C) In general, Aliyev said, Azerbaijan needs to "work as if we don't have any oil," and make the reforms and investments now to ensure that Azerbaijan's non-oil sectors are vibrant when Azerbaijan's oil reserves are exhausted in 30 or 50 years. To that end, Aliyev said that he had asked the Ministry of Industry and Energy to develop a plan for Azerbaijan's industrialization, with a particular focus on attracting foreign investment. Aliyev noted that he had also established a State Investment Committee (with USD 150 million in capital) that will provide seed capital to new enterprises. Separately, the GOAJ has unveiled a new USD 100 million investment fund for small and medium enterprises, which account for fully 75 percent of Azerbaijan's private sector. Aliyev said he personally would like to ensure that most of that investment fund is spent in agriculture. Noting

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that agriculture is Azerbaijan's second largest sector (after energy), Aliyev said that the health of Azerbaijan's agricultural sector also is very important from a social point of view. Continuing on social issues, Aliyev said that he was very aware of the dangers posed by unemployment among Azerbaijan's youth, and was building a network of sports facilities and theaters to ensure that youth -- particularly in the regions -- were occupied in productive activities and not tempted by the dangers of drugs and alcohol.

19. (C) Aliyev commented that Azerbaijan now has the resources to undertake all of these efforts on its own, without depending on loans from the international financial institutions. We can create a modern economy in a short period of time, he said, but must continue to rely on outside experts -- particularly from the IFIs -- to achieve Azerbaijan's objectives. Aliyev added that Azerbaijan was moving from an aid to a consultative relationship with the IFIs, but acknowledged that Azerbaijan's weak and under-developed banking sector posed challenges. Azerbaijan had started to change its lending practices this year, with a new program of preferential loans for first-time homebuyers that the GOAJ would evaluate after six months. (During a separate August 21 meeting with Chairman Lugar, Minister of Economic Development Heydar Babayev elaborated on some of the problems in Azerbaijan's banking sector. He said Azerbaijan's large number of banks (43) and low capitalization made the sector inefficient. Commercial lending terms were prohibitively difficult -- 25% over three years -- and salaries in general were too low to support these rates. Babayev commented that Azerbaijan hopes to address some of these problems through the new mortgage law and soft loans from the State Entrepreneurship Fund.)

¶10. (C) Aliyev said that in the immediate future, Azerbaijan's biggest challenge would be imposing internal restrictions on spending. The GOAJ already has seen "some element of the economy over-heating," Aliyev said, and the GOAJ needs to be "very accurate" in its spending plan. With "everyone waiting for BTC," Aliyev said that popular expectations are very high right now. The Government will fulfill people's expectations but will not escalate inflation. With a strong banking system and a market economy, Aliyev said that Azerbaijan can enter a new stage of economic development. Since independence, he said, Azerbaijan had always fought for an improvement in its standard of living. Now, the challenge is not to spend, to ensure that Azerbaijan's stunning economic growth does not lead to hyper-inflation. At the same time, Aliyev said, all social problems must be resolved.

¶11. (C) Aliyev said that his economic policy constitutes a mix of a social system and market economics. Noting that many elements of Azerbaijan's economy still have a strong social element, Aliyev said that a significant part of Azerbaijan's population is poor, and the government has a responsibility to take care of the poor. To that end, the GOAJ is working to improve the living conditions of Azerbaijan's large refugee and IDP population. Aliyev said that the GOAJ intends to move all refugees and IDPs into new housing by 2010. As part of the new housing complexes, the GOAJ also is building new hospitals and schools.

EDUCATION NEEDED TO BUILD HUMAN CAPITAL

¶12. (C) The real challenge, Aliyev said, is to develop Azerbaijan's human capital. He said the GOAJ built 300 new schools in 2005 and, by 2008, will ensure that none of Azerbaijan's 450,000 schools remains in poor condition, and that all have computers and internet access. Azerbaijan needs to have "skilled young managers who have studied abroad," he said, adding that he had asked the Ministry of Education to prepare a study on the young Azerbaijanis who are educated abroad. Very few study abroad on international programs; the rest, he said, must find their own financial resources. Aliyev hopes to rectify this situation by creating a GOAJ-funded program for "100 to 200" young

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Azerbaijanis to study in the West. Aliyev said he hopes to lure them back to good government jobs, in part by closing the gap between government and private sector salaries. Aliyev said he also is concerned that many well-educated young Azerbaijanis leave to pursue jobs abroad, commenting that Azerbaijan needs to create the conditions to keep people here. He added that he is considering creating a new Presidential Scholarship Fund. Over dinner, Mammadyarov and Pashayev elaborated on GOAJ plans to create a new Diplomatic Academy that will grow from a small training academy for Azerbaijani diplomats to a full-fledged four-year university that will train civil servants from across the Azerbaijani government and the entire region. Also over dinner, Aliyev said that far-reaching education reform is important. Mammadyarov noted that Azerbaijan had signed on to the Council of Europe's Bologna Education reform process and was committed to its implementation.

DEMOCRACY MUST BE PART OF THE VISION

¶13. (C) Briefing Aliyev on his earlier discussion with Speaker of Parliament Ogtay Asadov (ref), Lugar commented that Azerbaijan's continued democratic development would be equally important for its sustained stability and prosperity. Aliyev rued that popular perceptions of parliament in Azerbaijan differ from parliament's actual mandate. While

Azerbaijan's parliament should be dedicated to passing legislation, he said that Azerbaijani citizens have the idea that parliamentarians should be responsive to their individual needs, for example traveling regularly to villages to solve citizens' problems. Aliyev commented that during Azerbaijan's November 2005 parliamentary elections, well-known politicians were defeated for the first-time by "unknowns with resources" who promised to take care of problems in the regions. Aliyev complained that this development was not positive for Azerbaijan, adding that Members of Parliament should be lawyers and politicians who are skilled at passing legislation. Lugar cautioned that members of parliament can never forget who sent them to parliament, and have an obligation to try to serve their constituents' interests. While some members of parliament try to "bring home the bacon," there are others who will look at the country's overall interests.

¶14. (C) Aliyev said that while Parliament's role in Azerbaijan is not big, it is an important one and, for this reason, relations between the parliament and the president must be very good. Aliyev noted that Azerbaijan does not have a tradition of a strong parliament, but said this "probably" will change as Azerbaijan becomes more developed. For today's national interest, Aliyev concluded that it is important that parliament and the president work together to strengthen Azerbaijan's independence.

¶15. (C) In summary, Aliyev told Lugar that Azerbaijan has "a lot to do" to ensure that its own wealth translates into sustainable development. He recounted a recent Cabinet meeting in which, for the very first time in his presidency, Azerbaijan's energy programs were not discussed. Aliyev said Azerbaijan is focused on a program of "total modernization" that will develop Azerbaijan as an economically and politically strong and independent country, that is a true friend of its partners and can be useful when needed. Oil has played and will continue to play an important role in shaping Azerbaijan's future, Aliyev said, but for now, the focus is on broad-based development.

COMMENT

¶16. (C) A confident and relaxed Aliyev clearly relished the opportunity to share his strategic vision for modernization and sustainable development with Chairman Lugar. In fact, he told the Ambassador over dinner that he regretted he had not had more time to go into greater detail on specific issues. Like a good CEO, Aliyev has a solid vision in place; the real question is whether Azerbaijan has the capacity -- and the political will throughout the government -- to take on some of the difficult issues such as combating corruption and reining in government spending that will be necessary to

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ensure his vision is not overtaken by the Oil Curse. Aliyev is handicapped by the severe lack of technical capacity within the GOAJ, and his desire to maintain tight control over parliament will not help create the culture of transparency and accountability needed for Azerbaijan to successfully navigate the coming tsunami of energy revenue. Continued high-level USG engagement with the GOAJ, including dialogue with senior officials such as Senator Lugar, is needed to help Aliyev make the hard choices that lie ahead.

¶17. (U) CODEL Luga did not have the opportunity to review this message.
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